INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	4
Argument	11

CITATIONS

Cases:	
Kelley, John Co. v. *Commissioner*, 326 U. S. 521	11
Talbot Mills v. *Commissioner*, 326 U. S. 521	11
Statutes:	
Internal Revenue Code:	
Sec. 23 (26 U. S. C. 1940 ed., Sec. 23)	3
Sec. 115 (26 U. S. C. 1940 ed., Sec. 115)	3
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 23	2
Sec. 115	2
Revenue Act of 1938, c. 289, 52 Stat. 447:	
Sec. 23	3
Sec. 115	3
Miscellaneous:	
Treasury Regulations 94, Art. 23 (b)–1	3
Treasury Regulations 101, Art. 23 (b)–1	3
Treasury Regulations 103, Sec. 19.23 (b)–1	3

714127—46

In the Supreme Court of the United States

October Term, 1946

No. 373

PETIT ANSE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 47–69) is not reported. The opinion of the Circuit Court of Appeals (R. 127–130) is reported in 155 F. 2d 797.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 9, 1946. (R. 131.) The petition for a writ of certiorari was filed on August 8, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Does the record contain substantial evidence supporting the determination by the Tax Court that the payments made during the taxable years by taxpayer to holders of its "debentures" were not "interest" on "indebtedness", within the meaning of the controlling statutes?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.
>
> * * * * *
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
>
> (a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money

> or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> * * * * *

Sections 23 (b) and 115 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code (26 U. S. C. 1940 ed., Secs. 23 and 115) are identical with the above.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 23 (b)–1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *
>
> * * * * *
>
> * * * So-called interest on preferred stock, which is in reality a dividend theron, cannot be deducted in computing net income. * * *

Article 23 (b)–1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, and Section 19.23 (b)–1 of Treasury Regulations 103, promulgated under the Internal Revenue Code, are identical with the above.

STATEMENT

This controversy involves deficiencies in income and excess profits taxes for the years 1937, 1938 and 1939. (R. 69–70, 131.) The Tax Court made findings of fact as follows:

Avery Island, Louisiana, contains rock salt deposits. Judge Daniel Dudley Avery was the owner of the island at the outbreak of the Civil War. At the approximate date of his death in 1876 the ownership of Avery Island passed to his children, in whose hands and in the hands of their families, ownership, either directly or indirectly, has remained at all times material. (R. 48.)

Desiring to separate the agricultural interests from the salt mining interests in Avery Island, the four children of Judge Avery, as its owners, in 1903 organized a Louisiana corporation, Avery Planting & Improvement Company (sometimes below referred to as "Planting Company"). (R. 49.) In 1910 another Louisiana corporation called Avery Company was formed, to which eventually all four children of Judge Avery transferred their interests in the salt mines. (R. 50.) The charter of Avery Company, as well as that of the Planting Company, contained a prohibition on the sale or transfer of stock to others than stockholders, unless first offered for sale to the stockholders. (R. 50.)

Taxpayer is a Delaware corporation (R. 47) formed in 1924 in a reorganization of Avery Com-

pany and in order to take over its interests in Avery Island (R. 51). Taxpayer's stock was issued to stockholders of Avery Company in exchange for their stock in that company. In 1930, taxpayer was the owner of the salt deposit on Avery Island and was engaged in no activity other than that of holding title to this property, then leased for a term ending in 1951. Its only income was the rental from the lease. In 1930 and for some years prior thereto, the Planting Company was engaged only in leasing its property for mineral and oil exploration and for trapping and grazing purposes. (R. 51–52.)

Consideration was given to the reorganization and combination of taxpayer and the Planting Company, and in January 1931 taxpayer's directors adopted a plan which provided generally as follows:

1. Taxpayer would issue $1,000,000 of eight percent income debenture bonds and would offer these bonds to its stockholders pro rata, upon surrender by them in exchange therefor of 9,000 shares of its stock, each stockholder to surrender nine-fifteenths of the stock held by him or her respectively. (R. 52.)

2. Taxpayer would offer pro rata to the stockholders of Planting Company, in exchange for 1,000 shares they held in that company, 4,000 shares of the 9,000 shares of taxpayer's stock which were to be surrendered. (R. 52.)

3. If the plan should be approved, the charter

of taxpayer would be amended to prohibit it from engaging in any active business involving liability and to restrict its corporate purpose to the holding, care, upkeep, and leasing of its properties. (R. 52–53.)

4. After execution of the plan, the "capitalization" of taxpayer would be eight percent income debenture bonds, $1,000,000; shares of stock (no par value), 10,000. (R. 53.)

The debentures issued pursuant to this plan were dated November 1, 1931, and were designated "Eight Per Cent. Registered Non-Cumulative Fifty Year Income Gold Debenture", with a stated due date of November 1, 1981. They recited that they were issued under and subject to an indenture of even date, entered into between taxpayer and Joseph S. Clark, Jr., and Frank McLoughlin, as trustees. The indenture provided that beginning on February 1, 1932, and out of taxpayer's surplus net income for the fourth quarter of the calendar year 1931, and thereafter quarterly on May 1, August 1, and November 1, out of taxpayer's surplus net income for corresponding quarters, taxpayer's directors might pay interest on the debentures to the extent such surplus net income should be sufficient for the purpose, and, if not sufficient, then pro rata. Although the interest periods were named and the particular surplus net income was described out of which the interest at such periods might be paid, the directors had the right to dis-

tribute at any time, on account of any quarterly installment of interest payable in any calendar year, any surplus net income of that quarter, or of any other quarter of such calendar year, available for the purpose; but the total amounts distributed as interest at or for the four quarterly interest periods in any calendar year were not to exceed eight percent. (R. 53–54.)

The term "surplus net income" was defined in the indenture as follows (R. 54, 137):

> * * * the surplus remaining after deducting from the gross earnings or income of the Company all of its operating expenses, including maintenance, repairs, renewals, replacements, insurance, losses, damage claims and proper charges in respect of depreciation and obsolescence and all sums paid or reserved for taxes, assessments or other governmental charges and such sums paid or reserved for alterations, additions and improvements as in the judgment of said Board may be deemed necessary or desirable. * * *

Interest upon the debentures was not to be cumulative. No interest was to be due and payable unless declared by the board of directors out of taxpayer's surplus net income, and their determination as to whether there was any "surplus net income" in any year and its amount was binding upon taxpayer and the debenture holders. (R. 54, 138.) When the surplus net income for a given year is sufficient to pay in full the interest

for that year and the full amount of eight percent for that year is not paid, the directors may at any time after such year use such surplus net income to pay in full the unpaid portion of the interest for such given year. (R. 54.)

By giving 60 days notice, taxpayer has the right to redeem any or all of the debentures on any interest date, prior to maturity; selection of the particular debentures to be redeemed is to be determined by taxpayer's board of directors, in its discretion. (R. 54–55.)

In the event of default by taxpayer in the payment of interest or of principal, or in the performance of any of the provisions of the indenture, and when the default has continued for a period of 60 days without being remedied, the trustees may, and upon request of 60 percent of the holders in amount of debentures outstanding shall, declare the principal of all the debentures due and payable. The holders of 60 percent have the right to waive any event of default and its consequences, and may rescind any action of the trustees in declaring the principal of the debentures due and payable. (R. 55.)

All rights of action in respect of the debentures are vested exclusively in the trustees, and no debenture holder has any right to bring any action, at law or in equity, upon any debenture or growing out of any of its provisions or of the indenture or for the enforcement of the indenture, unless the trustees have refused and neglected to

institute proper proceedings for a period of 60 days after having been requested to do so by the holders of 60 percent in amount of the debentures outstanding. (R. 55.)

The indenture was not to be recorded or registered in any public office, and further provided that the only parties interested in taxpayer, as debenture owners, were descendants of Judge Avery, and that it was their intention that no party should become the owner of any of the debentures except descendants of Judge Avery, and that each debenture holder agreed that, before selling his debentures to any one other than a debenture holder, he would first offer them to taxpayer, which would have a 30 day option to purchase them at the same price at which a bona fide offer had been received from outside sources. (R. 55–56, 139–141.)

Taxpayer and all of its property were to be liable for the payment of the debentures. Debenture holders, as such, were not given any right to participate in the management of the business. (R. 56.)

The trust indenture was executed and the debentures were issued as of November 1, 1931, to the fifteen descendants of Judge Avery, who had been stockholders of taxpayer and of the Planting Company at the time of the reorganization. (R. 57–58.) Nevertheless, taxpayer's balance sheets at December 31, 1931, and December 31, 1932, appearing as parts of its 1931 and 1932 income tax

returns, indicate that the issuance of the debentures under the plan was not reflected on taxpayer's books until sometime in 1932. Except for land valued at $62,500, buildings at $1,200, and $489.16 in cash received in July 1932, upon liquidation of the Planting Company, no new assets were received upon the issuance of the debentures, taxpayer's assets merely being written up as good will in the amount of $932,010.64. (R. 58.)

From the organization of taxpayer through 1927, the $20,000 fixed annual rental, payable monthly, under the salt mining lease and the quarterly rentals based on production were paid directly by the mining company to its stockholders, in proportion to their stockholdings. During 1928, and up to November 1, 1931, the effective date of the reorganization, these rentals were first paid to taxpayer and by it paid over to the stockholders in the same proportions. (R. 59.) The payments actually made by taxpayer's treasurer, whether from "receipts" or out of "surplus net income", after November 1, 1931, were to exactly the same individuals and in the same proportions as before November 1, 1931, except that for the months of January through October 1931, distributions allocable to E. A. McIlhenny, John A. McIlhenny, Paul A. McIlhenny, and Rufus A. McIlhenny, to the extent of $27.27 each, apparently had been paid to Sarah A. Mc-

Ilhenny. Subsequently and through the taxable years, except for some small changes resulting from shifts of debentures between various members of the Avery family, the distributions or payments to the debenture holders and/or stockholders of taxpayer continued to be made in the same proportions as before the reorganization. (R.60–62.)

The deductions of $34,577.11, $32,661.88 and $23,878.14 taken by taxpayer in its income tax returns for 1937, 1938 and 1939, respectively, as interest paid on its debentures in those years, were disallowed by the Commissioner in determining the deficiencies presently involved. (R. 64.) The Commissioner's determinations were sustained by the Tax Court (R. 64–69), and by the court below (R. 128).

ARGUMENT

The question whether payments upon hybrid corporate securities such as are here involved are to be treated as "interest" or as "dividends" was recently considered by this Court in two cases, *John Kelley Co.* v. *Commissioner* and *Talbot Mills* v. *Commissioner,* reported together at 326 U. S. 521. The opinion in those cases also sets forth the narrow scope of review with respect to such questions in cases coming from the Tax Court. The decision of the court below in the instant case is in accord therewith, and it would seem that no

useful purpose would be served by further review herein. The petition should be denied.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.
DOUGLAS W. MCGREGOR,
Assistant Attorney General.
SEWALL KEY,
A. F. PRESCOTT,
I. HENRY KUTZ,
Special Assistants to the Attorney General.

SEPTEMBER 1946.

U. S. GOVERNMENT PRINTING OFFICE: 1946